1923

Expense of borrowed money

Anonymous

Recommended Citation
Haskins & Sells Bulletin, Vol. 06, no. 12 (1923 December), p. 92-94

on whether the stock is full paid and value was received. But again this is not important in this case because the question is one of determining the respective interests of shareholders in the invested capital and how each would be affected by capital impairment. Thus it appears to make no difference whether the position in liquidation of the respective classes of shareholders is determined on a share or on a money-amount basis. The only complication which appears is that represented by non-par preferred stock having a redemption value which, if there were no legal question involved, might be easily gotten around by considering such stock as one would ordinary preferred stock with a fixed par value.

Regardless of the form which share-representation may take, that is, whether the shares are with, or without, par value, caution should be exercised in expressing the relation of the respective classes of shareholders to the enterprise and the effect of a capital deficit on the invested capital of the respective classes. A combination of all the invested capital in one total on the balance sheet with the application thereto of a capital deficit may, in certain instances, be indicated; for example, where there are both common and preferred stock and the deficit exceeds the invested capital represented by the common stock. As a rule, however, it seems preferable to show the share-interests as separate items, relating to that class which is affected, any existing capital deficit.

Reviewing, the discussion then, it appears, generally speaking, that a deficit shown on the asset side of a balance sheet is inconsistent with classification; that if not misleading, at any rate it does not help the reader to obtain with the least expense of effort a true picture of the capital situation. There may be, however, cases of sole proprietorship and copartnership wherein the deficit would have to be shown on the asset side, since it would not be proper to deduct it from the liabilities. In deducting a capital deficit consideration must always be given to the facts of capital interest, and extreme care had in cases where new conditions spring up in connection with shares having no par value.

Hard and fast rules applied without thought are dangerous. Accountancy practice needs to be purged of many antiquated notions and methods. The forward steps need to be carefully watched, but they need to be taken nevertheless. There is no reason why accountants should go on showing capital deficits among the assets, because they have always been shown that way, if careful study and sound judgment indicate that in some, if not most cases, the true situation is better portrayed by deducting them from the invested capital.

The Expense of Borrowed Money

ONE of the well-recognized principles underlying the statement of financial operations is that it shall show the true cost of goods, services, or privileges sold, together with the expense of conducting and of financing the enterprise. If a fine technical distinction in the use of terms may be made, cost usually refers to the product, or to physical property; expense, to an activity or phase of operation. Hence, reference is made variously to manufacturing cost, marketing cost, cost of property, selling expense, administrative expense, or interest expense. Used in the last sense the meaning is, expense to the enterprise of borrowed money or capital which is utilized in the conduct of the business.

The expense of borrowed money comprehends several classes of interest. The classification is derived largely from the legal instruments on which the funds are borrowed. Thus, there is interest on bonds, debentures, notes, etc. Some interest is paid as it matures; some in advance. Not all interest constitutes expense, since at times and under certain theories it is included in cost of goods or property. Frequently the charging of interest to expense is deferred and the unabsorbed portion carried as an asset in order to properly equalize the effect on operations.

Discount was originally a term of banking origin and used to denote interest paid in advance. It has in more recent times become enlarged in its meaning and used in the case of bonds and similar securities to describe the difference between the par, or price at which the obligations must be redeemed, and some lesser price at which the securities were sold. It is a well-settled principle that this difference should be spread over the life of the obligations and thereby serve to increase the annual charge for interest at the agreed rate. Out of this practice comes the term, "effective rate."

The expense of money, or capital borrowed on obligations issued at a discount, is determined by the effective rate. There need be no mystification as to this term, even though it is used in connection with bond evaluation and so used involves compound interest. Stripped of all actuarial technicalities, it means, when applied to obligations sold below par, nominal, or stated rate of interest, plus a pro rata share of the discount. Failure to include the discount along with the interest frequently would result in a misleading showing of interest, the extent of which would depend on the margin of discount and length of time the obligations would have to run. The true rate per cent. of interest expense is ascertainable only when the two factors of interest and discount are combined.

While the principle involved in bond discount is simple enough, cases which arise in practice sometimes have relations which at the start of consideration tend to confusion. A corporation having borrowed money under one mortgage on ten distinct issues of bonds had to deal not only with the question of discount, but the fact that some of the money was used for construction purposes. Here the expense of borrowed money for a given year presented certain complications. The principle, however, should still be clear up to a certain point, and careful reasoning from that point on should lead to an accurate conclusion.

Taking the issues one by one, determining for each the stipulated interest, adding thereto the proportion of discount, finding the effective interest for all issues, and applying that to the total obligation under the mortgage would give the composite annual rate of effective interest. Thus far the steps presumably are clear. But before going further another principle must be recognized and adopted as a basis for procedure, to wit: interest on funds used in construction is a proper charge to cost of construction from the time when such funds are put into use incident to construction up to the point where the property is put into operation. This, obviously, is a general principle and ignores some of the fine points susceptible of discussion in the field of public utilities. The principle, however, is well recognized.

Accepting, then, the principle of charging interest to construction, it follows that there must be complementary relief of the interest expense. The composite rate on funds borrowed under the mortgage having been determined, it is a simple matter to apply the rate as representing the expense per centum, to funds used in construction, for the periods of time such funds were so employed. The effect will be to capitalize such interest, but correspondingly to relieve the interest expense account and thereby make the interest expense account show as a net result the expense for money borrowed and used for operating or for funding purposes.

The successful treatment of a case such as the foregoing calls for sound technical procedure. A basis of theory, however, is obviously required. A knowledge of theory is but a knowledge of principles. Procedure is a matter of application. The steps indicated in an orderly solution of an accounting problem are the analysis of the case to determine the facts; lining up the facts according to a classification of principles; treating the facts as indicated by the principles. Sound technical procedure is but the application of sound principles.

There are three outstanding principles which must be recognized in the above case:

First, net income results should show the true expense of borrowed money;

Second, where interest-bearing obligations have a discount feature the periodical proportion of discount must be added to the contractual interest;

Third, where funds obtained through the medium of such obligations are used for construction purposes, interest corresponding to such use should be capitalized and the expense of borrowed money relieved accordingly.

Prize Competition

THE firm offers three prizes of $100, $50, and $25, respectively, for the three best essays to be submitted on the subject of "How May We Improve the Quality of Our Service to Clients?"

The competition will be open to all members of the organization, in grades not higher than that of supervising accountant and will close December 31, 1923. Envelopes bearing postmarks prior to midnight on such date will be accepted.

Essays submitted in competition must be limited to fifteen hundred words, typewritten on sheets 8½ x 11, securely fastened together on the left-hand side, and preferably protected by a suitably inscribed cover.

The essays will be judged by a committee which will take into consideration arrangement of content with a view to facilitating easy reading, clearness of expression, and practicability of the suggestions offered.

Essays should be unsigned but marked with a *nom de plume* and accompanied by a sealed envelope bearing the same *nom de plume;* the envelope to contain a card giving the name, address, and practice office of the author.

We hope everyone in the organization who is eligible will enter the competition and give free expression to his thoughts on the subject.

Miss Burns Departs

AFTER nearly six strenuous years as general librarian, Miss Burns has laid aside the cares of business and gone with an intimate friend to pass the winter in southern France.